7812

In the United States Circuit Court of Appeals

For the Ninth Circuit.

THE REPUBLIC SUPPLY COMPANY OF CALIFORNIA, a corporation,

Complainant,

vs.

RICHFIELD OIL COMPANY OF CALIFORNIA, a corporation,

Defendant.

SECURITY-FIRST NATIONAL BANK OF LOS ANGELES, as Trustee, GEORGE ARMSBY, F. S. BAER, HARRY J. BAUER, STANTON GRIFFIS, ROBERT E. HUNTER and ALBERT E. VAN COURT, known and designated as Richfield Bondholders' Committee,

Appellants and Cross-Appellants,

vs.

UNIVERSAL CONSOLIDATED OIL COMPANY, a California corporation,

Intervenor, Appellee and Cross-Appellant.

THE CHASE NATIONAL BANK OF THE CITY OF NEW YORK, BANK OF AMERICA, a corporation, PAN AMERICAN PETROLEUM COMPANY, a corporation, WILLIAM C. McDUFFIE, as Receiver for Pan American Petroleum Company, a corporation, RICHFIELD OIL COMPANY OF CALIFORNIA, a corporation, UNITED STATES OF AMERICA, THE REPUBLIC SUPPLY COMPANY OF CALIFORNIA, a corporation, CITIES SERVICE COMPANY, a corporation, ROBERT C. ADAMS, THOMAS B. EASTLAND, EDWARD F. HAYES and RICHARD W. MILLAR, known and designated as Pan American Bondholders' Committee, G. PARKER TOMS, ROBERT C. ADAMS, F. S. BAER, ROBERT E. HUNTER, HENRY S. McKEE and RICHARD W. MILLAR, known and designated as Richfield Pan

(Continued on Inside Cover.)

BRIEF OF APPELLANTS AND CROSS-APPELLEES SECURITY-FIRST NATIONAL BANK OF LOS ANGELES, AS TRUSTEE, GEORGE ARMSBY, F. S. BAER, HARRY J. BAUER, STANTON GRIFFIS, ROBERT E. HUNTER AND ALBERT E. VAN COURT, KNOWN AND DESIGNATED AS RICHFIELD BONDHOLDERS' COMMITTEE.

FILED
MAY - 6
PAUL P. O'BRIEN,
CLERK

Parker, Stone & Baird Co., Law Printers, Los Angeles.

TOPICAL INDEX.

PAGE

Statement of the case 4

Specification of the errors relied upon 13

Argument 18

1. The federal equity doctrine as to the tracing of trust funds is controlling in this case. That doctrine requires a strict tracing of actual trust funds into a specific fund or into specific property 25
2. Under the federal decisions mere proof of the purchase of properties out of a fund in which trust and private funds have been commingled is insufficient to show a tracing of the trust funds into such properties 26
3. A mere showing that trust funds have gone to swell the assets of an insolvent is insufficient to impress a trust upon properties acquired through the use of the general funds of the insolvent with which the trust funds have been blended 42
4. Purchases made out of a commingled fund are not ipso facto chargeable with a trust 48
5. The principle of in re Oatway has never been followed in the federal courts to the extent of doing away with the strict tracing principle in cases dealing with the acquisition of real or personal property out of a commingled fund 57
6. If it be assumed that the impressment of a trust upon the properties involved was proper, the amount thereof could not exceed the amount of the lowest balance in the account prior to a given purchase and subsequent to the last deposit of trust moneys therein, such low balance to be computed by deducting all withdrawals from the account during each day from the opening balance of such day, as held by the master and the court 65

Conclusion 75

TABLE OF AUTHORITIES CITED.

PAGE

American Surety Co. v. Jackson, 24 Fed. (2d) 768................50, 54

A. O. Brown & Co., In re, 193 Fed. 24........................40, 44, 67, 73

Beard v. Independent District, 88 Fed. 375.............................. 25

Board of Commissioners v. Strawn, 157 Fed. 49..............42, 53, 54

Brennan v. Tillinghast, 201 Fed. 609..........................22, 59, 60, 63

City of Spokane v. First National Bank of Spokane, 68 Fed. 982 50

Ellerbe v. Studebaker Corp., 21 Fed. (2d) 993.............................. 46

Empire State Surety Co. v. Carroll County, 194 Fed. 593......42, 58

Equitable Trust Co. v. Conn. Brass & Manuf. Co., 10 Fed. (2d) 1913.. 51

Frelinghuysen v. Nugent, 36 Fed. 229..............................23, 34, 36

J. M. Acheson Co., In re, 170 Fed. 427....................................48, 55

John Deere Plow Co. v. McDavid, 137 Fed. 802........................ 25

Kemp v. Elmer Co., 56 Fed. (2d) 657.. 51

Knatchbull v. Hallett, 13 Ch. D. 696..21, 23

McIntyre, In re, 185 Fed. 96, 108.. 25

Mitchell v. Dunn, 211 Cal. 129.. 64

Oatway, In re, 2 Ch. D. 356.. 57

Pacat Finance Corporation, In re, 27 Fed. (2d) 810.................... ....22, 59, 60, 61, 67

People v. California Safe Deposit Company, 175 Cal. 756............ 65

Peters v. Bain, 133 U. S. 670.. ....23, 24, 26, 33, 36, 41, 46, 56, 57, 60

Schumacher v. Harriett, 52 Fed. (2d) 817.................................. 46

Schuyler v. Littlefield, 232 U. S. 707........37, 39, 40, 57, 58, 60, 66

Smith v. Town of Au Gres, 150 Fed. 258.................................... 53

Southern Cotton Oil Co. v. Elliotte, 218 Fed. 567........................ 52

Spokane County v. First National Bank, 68 Fed. 979.................. 51

In the United States
Circuit Court of Appeals
For the Ninth Circuit.

THE REPUBLIC SUPPLY COMPANY OF CALIFORNIA, a corporation,

Complainant,

vs.

RICHFIELD OIL COMPANY OF CALIFORNIA, a corporation,

Defendant.

SECURITY-FIRST NATIONAL BANK OF LOS ANGELES, as Trustee, GEORGE ARMSBY, F. S. BAER, HARRY J. BAUER, STANTON GRIFFIS, ROBERT E. HUNTER and ALBERT E. VAN COURT, known and designated as Richfield Bondholders' Committee,

Appellants and Cross-Appellants,

vs.

UNIVERSAL CONSOLIDATED OIL COMPANY, a California corporation,

Intervenor, Appellee and Cross-Appellant.

THE CHASE NATIONAL BANK OF THE CITY OF NEW YORK, BANK OF AMERICA, a corporation, PAN AMERICAN PETROLEUM COMPANY, a corporation, WILLIAM C. McDUFFIE, as Receiver for Pan American Petroleum Company, a corporation, RICHFIELD OIL COMPANY OF CALIFORNIA, a corporation, UNITED STATES OF AMERICA, THE REPUBLIC SUPPLY COMPANY OF CALIFORNIA, a corporation, CITIES SERVICE COMPANY, a corporation, ROBERT C. ADAMS, THOMAS B. EASTLAND, EDWARD F. HAYES and RICHARD W. MILLAR, known and designated as Pan American Bondholders' Committee, G. PARKER TOMS, ROBERT C. ADAMS, F. S. BAER, ROBERT E. HUNTER, HENRY S. McKEE and RICHARD W. MILLAR, known and designated as Richfield Pan American Reorganization Committee, WILLIAM C. McDUFFIE, as Receiver of Richfield Oil Company of California, SECURITY-FIRST NATIONAL BANK OF LOS ANGELES, a national banking association, PACIFIC AMERICAN COMPANY, a corporation, AMERICAN COMPANY, a corporation, MANUFACTURERS TRUST COMPANY OF NEW YORK, a corporation, CITIZENS NATIONAL TRUST & SAVINGS BANK OF LOS ANGELES, a national banking association, FIRST NATIONAL BANK AND TRUST COMPANY OF SEATTLE, a national banking association, CONTINENTAL ILLINOIS BANK AND TRUST COMPANY, a corporation, THE FIRST NATIONAL BANK OF CHICAGO, a national banking association, CHEMICAL NATIONAL BANK AND TRUST COMPANY, a national banking association, and CALIFORNIA BANK, a corporation, M. W. LOWERY, HENRY S. McKEE, O. C. FIELD, R. R. TEMPLETON, known and designated as Richfield Unsecured Creditors' Committee,

Appellees.

BRIEF OF APPELLANTS AND CROSS-APPELLEES SECURITY-FIRST NATIONAL BANK OF LOS ANGELES, AS TRUSTEE, GEORGE ARMSBY, F. S. BAER, HARRY J. BAUER, STANTON GRIFFIS, ROBERT E. HUNTER AND ALBERT E. VAN COURT, KNOWN AND DESIGNATED AS RICHFIELD BONDHOLDERS' COMMITTEE.

Statement of the Case.

Prior to November 13, 1929, Richfield Oil Company of California (hereinafter referred to as Richfield) obtained control of the Board of Directors of Universal Consolidated Oil Company (hereinafter referred to as Universal) and thereafter and prior to January 15, 1931, effected the transfer of Universal funds to the Richfield general banking account in the Security-First National Bank of Los Angeles in a net sum of $1,625,000.00. [Tr. p. 97.] The Richfield account in question was an ordinary checking account and the Universal funds, when deposited therein, were commingled with Richfield moneys concurrently on deposit. [Tr. p. 97.] At the time of the first deposit of Universal moneys on November 13, 1929, Richfield had a large balance in the account. [Tr. pp. 97, 98.] That balance fluctuated from day to day in accordance with the deposits and withdrawals constantly being made by Richfield. [Tr. p. 98.] The deposits from sources other than Universal amounted to $81,903,908.39 from November 13, 1929, to January 14, 1931. [Tr. p. 98.] By January 8, 1931, one week before the appointment of the Richfield receiver, the account had been wholly depleted and there existed an overdraft of some $18,000.00 at the close of business on that day. [Tr. p. 98.]

Upon these facts Universal intervened in the consolidated foreclosure proceeding then pending against the properties subject to the Richfield bond indenture in order to obtain an adjudication of priority in its favor over the bond issue as to certain parcels of property which it claimed had been purchased by Richfield through the use of Universal funds assertedly in the commingled account. [Tr. p. 67.] The issues joined as to the allegations of Universal's bill in intervention were duly referred to the Honorable William A. Bowen, as Special Master, for hearing, which hearing was consolidated with that based upon the general claim which Universal had also filed against Richfield in the receivership proceeding and which general claim was later allowed. The Special Master found that the transactions between Universal and Richfield were not in the nature of loans or advances from the former to the latter, as was contended, but actually consisted of misappropriations which rendered Richfield a constructive trustee for the benefit of Universal as to all moneys obtained from the latter. The propriety of this finding is not questioned here.

Secondly, the Special Master found that Universal had succeeded in tracing an aggregate sum of $403,993.92 into certain properties described in his report [Tr. pp. 205-206] and accordingly recommended that a trust superior to any right, title, interest or lien of appellant Bank as Trustee under the bond issue be impressed upon such properties. The properties in question, together with the amounts as to which they were declared subject to the trust in favor of Universal, are set forth *infra* in the exceptions to the report of the Special Master contained in the specification of errors relied upon herein.

Timely exceptions were filed to the Master's Report both by appellants [Tr. p. 208] and by Universal [Tr. p. 214], which exceptions were duly overruled by the court and the report approved. [Tr. pp. 32, 36.] It may be stated, more or less parenthetically, that appellant's exceptions were filed on the theory that the evidence did not show any actual tracing of the commingled funds into the properties involved, such as is required by the legal and equitable principles applicable to such a situation. On the other hand, Universal's exceptions were filed upon the theory that it had succeeded in tracing an even larger amount ($849,864.25) and hence, that the Master should have declared a trust in that sum. These conflicting contentions reflect the questions which are presented for determination respectively in this appeal and in the cross-appeal of Universal.

The manner in which these questions are raised is perhaps best illustrated by setting forth the formula employed by the Master in applying his theory as to the tracing of Universal funds from the commingled account into the properties as to which he recommended the impressment of a trust. We quote from his report [Tr. p. 173]:

> "A trustee deposits trust money in an account containing his own funds, pays for an identified piece of property out of the mixed fund, and afterwards dissipates the remainder. Between the deposit and the payment he has daily deposited his own funds and daily withdrawn from the mixed fund, but the account has never been exhausted. The question is,

> whether a trust is to be declared in the identified piece of property for the payment thereon, limited by the amount of the trust money deposited or by the intervening low balance in the account, whichever is less."

The Master recommended that under such circumstances a trust should be declared and the court approved this recommendation.

The question as to whether any trust may be declared under this "low balance" theory constitutes the main question involved in this appeal. As to the cross-appeal of Universal, however, the question involved is whether or not the Master applied the proper "low balance" test in impressing the trust which he did declare.

Three theories as to the proper low balance were advanced by the parties, assuming, of course, the propriety of declaring a trust based upon any low balance theory. These were, first, the lowest daily closing balance in the Richfield banking account; second, the lowest intermediate posted balance shown on the Bank's books during the course of business on a given day; and, third, the low balance ascertained by deducting from the opening balance of any given day all checks cleared each day by crediting deposits made during that day. [Tr. pp. 147-148.]

The Master chose the third method. [Tr. p. 150.] Briefly, it was his view that the first method did not apply "for the reason that by its nature it necessarily disregards the actual order of deposits and withdrawals in point of time, and consequently does not reflect the true state of the account at any time since the previous

closing balance." [Tr. p. 151.] He disregarded the second method because the intermediate daily balance theory disregarded the actual order of deposits and withdrawals in point of time due to the fact that under the practice of the Bank such posting ignores both deposits and withdrawals which might have been made prior to the actual posting without the records of such deposits or withdrawals being before the posting bookkeeper at the time he cast his balance. [Tr. pp. 148-150.] In view of these facts it became obvious that the third method, that of deducting all outgoing checks from the opening daily balance, was the only way in which Universal could sustain its burden of showing with the requisite certainty what the low balance on any given day actually was, upon an "irreducible minimum" theory. Appellants agree with the conclusion of the Master as to the propriety of applying the method in question if, and only if, it be held that any low balance method is proper in effecting a tracing of trust funds into specific properties. The following schedule which is reproduced from the statement of evidence set forth in the agreed statement of the case [Tr. pp. 102-105] sufficiently sets forth not only the results of the three alternative methods of ascertaining the low balance above referred to, but also all of the evidence necessary in the determination of both the appeal of these appellants and the cross-appeal of cross-appellant Universal. The "Universal deposits" referred to in the schedule, of course, are deposits of the misappropriated Universal moneys in the general checking account of Richfield.

(1) Date	(2) Universal Deposits	(3) Lowest Daily Closing Balances Between Takings of Universal Funds	(4) Lowest Posted Balances Shown on Bank's Books During any Day Between Takings of Universal Funds	(5) Lowest Balance Ascertained by Deducting From Opening Balance All Checks Cleared Each Day Before Crediting Deposits Made During the Same Day	(6) Property on Which Payments Were Made and Amount Paid on Such Property from Said Bank Account	
1929						
Nov 13	$750,000.00					
" 19		$272,704.61	$209,198.80	$ 93,635.65		
" 27			198,719.90			
" 29					$ 50,000.00	Parcel 5
" 30					44,540.00	Parcel 2
" 30					500.00	Parcel 1
Dec 9					35,421.75	Parcel 9
" 23					164,746.20	Parcel 8
" 23					168,663.06	Parcel 7
" 23					190,914.94	Parcel 6
" 24				76,032.84 (red)		
" 31					49,385.00	Parcel 2

1930								
Jan	3					500.00	Parcel	1
"	3					50,000.00	Parcel	5
"	20	200,000.00						
"	23		466,764.36	466,764.36	336,646.20			
"	24				308,662.67			
"	27					500.00	Parcel	4
"	29					221,202.08	Parcel	10
"	29					50,000.00	Parcel	5
"	30					53,680.00	Parcel	2
"	30		464,148.47	462,088.47		500.00	Parcel	1
Feb	1		447,704.86	443,916.47				
"	15	500,000.00	(red)	172,136.10	222,642.41 (red)			
"	24		296,779.62	20,925.52	20,879.26			
"	25	100,000.00	252,760.24	122,941.84	128,412.10 (red)			
"	26			204,342.03	204,138.29			
"	27	100,000.00			272,948.76			

Mar	1				34,332.84	Parcel 3
"	1				48,000.00	Parcel 2
"	4			239,919.57		
"	5			203,185.63	10,625.00	Parcel 11
"	6			17,400.43		
"	8	209,201.80				
"	10		113,324.49			
"	12				50,000.00	Parcel 5
"	18		53,259.91			
"	22				7,500.00	Parcel 1
"	25				34,332.43	Parcel 3
"	28				50,000.00	Parcel 2
Apr	2				50,000.00	Parcel 5
"	3				500.00	Parcel 1
"	7				4,500.00	Parcel 4
"	16			8,520.06		
"	21				34,332.43	Parcel 3

SCHEDULE A (Continued)

(1)	(2)	(3)	(4)	(5)	(6)	
1930						
Apr 26					$ 50,000.00	Parcel 5
" 28					50,000.00	Parcel 2
May 5		$140,878.03			825.00	
Jun 6	$75,000.00			$ 114,164.03 (red)		
" 7		168,222.42				
" 18			$69,303.89			
" 21				122,078.81 (red)		
" 25					34,332.43	Parcel 3
" 27			45,336.49			
" 28					55,700.19	Parcel 2
Jul 14				1,679,420.83 (red)		
" 15					34,332.43	Parcel 3
" 17					50,000.00	Parcel 5
" 31					500.00	Parcel 1

Specification of the Errors Relied Upon.

Inasmuch as the error alleged concerns a ruling of the court upon the report of a Master and consisted in the approval of such report and the overruling of all exceptions thereto, we here set forth the exceptions [Tr. p. 208] filed by appellants to such report:

> "Now comes Security-First National Bank of Los Angeles, a national banking association, plaintiff in the above entitled cause, and excepts to the report of the Honorable William A. Bowen, Special Master herein, filed in the office of the clerk of this court on the 26th day of May, 1933, in the following particulars, to-wit:
>
> 1. To the finding of fact and/or conclusion of law (Report p. 82, line 26) that the lien of the bond or trust indenture sought to be foreclosed herein is subject to the trust interest of intervenor, Universal Consolidated Oil Company, a corporation, as found and declared by said Special Master as to the parcels of property specified in said report.
>
> 2. To the finding of fact and/or conclusion of law (Report p. 76, line 24) that said intervenor has sufficiently identified and traced its funds into the various parcels specified in the report of said Special Master and hereinafter specified, either in the amounts set forth or otherwise.
>
> 3. To the finding of fact and/or conclusion of law (Report p. 57, line 13) that the various parcels specified in said report and hereinafter specified either in toto or to the respective amounts or to the extent of the trust imposed upon them in favor of said intervenor constitute the property of intervenor in a substituted form.

4. To the conclusion of law (Report p. 83, line 4) that said intervenor is entitled to have a trust imposed upon the various parcels specified in said report and hereinafter specified either in the amounts specified therein or in any amounts whatever.

5. To the conclusion of law (Report p. 76, line 24) that the evidence herein constitutes a sufficient tracing and identification of the funds of said intervenor to warrant the imposition of a trust in favor of said intervenor upon the various parcels specified in said report and hereinafter specified either in the amounts set forth therein, or in any amounts whatever.

6. To the conclusion of law (Report p. 67-a, line 6) that the investments revealed by the evidence (to-wit, the purchases by defendant Richfield Oil Company of California, a corporation, of the parcels specified in said report and hereinafter specified) should be attributed either in whole or in part to the trust funds of intervenor then and there in the possession of said defendant and commingled with private funds belonging to said defendant.

7. To the conclusion of law (Report p. 67-a, line 6) that in the case of purchases of real or personal property made by a trustee out of a fund in which trust and private funds had theretofore been commingled, the trust moneys may be traced into such properties wholly through the application of presumptions and wholly without evidence of any actual devotion of such trust funds or any part thereof as distinguished from the commingled funds to the respective purchases in question.

8. To the failure of said Special Master to conclude that the evidence was insufficient to support a finding that intervenor had actually traced into the

parcels specified in said report and hereinafter specified any of the trust funds of intervenor formerly in the possession of defendant Richfield Oil Company of California, a corporation, as distinguished from the commingled fund in which said trust funds and the private funds of said defendant were blended.

9. To the failure of said Special Master to conclude and to declare that mere proof of purchases out of a fund in which trust and private moneys have been commingled is wholly insufficient to warrant the imposition of a trust upon the property so purchased.

10. To the recommendations, and each of them, of said Special Master as embodied in his said report (p. 83, line 4), to-wit:

(a) That a trust be declared and enforced in favor of Universal Consolidated Oil Company, a corporation, in the amounts specified below and upon such right, title and interest as may appear to be vested in Richfield Oil Company of California, a corporation, and its receiver, and superior to any right, title, interest or lien of this plaintiff under the bond or trust indenture sought to be foreclosed herein in and to the following properties and parcels described in said report, to-wit:

Parcel 1.	"Franklin & Vermont Service Station", real property. $	492.60
Parcel 2:	"Delaney Producing Property", leaseholds.	103,442.33
Parcels 3 and 4:	Ten storage tanks, personal property.	91,881.85
Parcel 5:	"Mull Property" real property.	500.00

Parcel 6:	"Vapor Recovery Plant", personal property.	34,332.84
Parcel 7:	106,000 shares of Universal Stock, Certs. LX:26, 27, 28 and 32	162,719.30
Parcel 8:	5,100 shares of Universal Stock, cert. LX 31	10,625.00
		$403,993.92

(b) That upon any sale to be had in this action the aforesaid parcels be offered for sale and sold separately from each other and from all other property, and that Universal Consolidated Oil Company be allowed a first charge upon the gross proceeds of the sale of each of said parcels in the amount above specified in respect thereof, the amount of each sale to be a charge upon any surplus realized from such sale over the amount receivable as aforesaid by said Universal Consolidated Oil Company, a corporation; and

(c) That jurisdiction be retained for the purpose of awarding such other relief as may appear to be equitable for the enforcement of said trust in the event there shall be a failure to effect a sale in the case of any parcel or parcels.

Dated this 15th day of June, 1933.

O'Melveny, Tuller & Myers
and Pierce Works
and Clinton La Tourette

Solicitors for Plaintiff, Security-First National Bank of Los Angeles, a national banking association."

The foregoing exceptions were overruled and the report of the Master approved by order of the District Judge duly made and entered [Tr. pp. 36, 42], exceptions being allowed to appellant. [Tr. pp. 39, 44.]

Appellant specifies as error relied upon by it upon this appeal, and states that the order appealed from is erroneous by reason of, the action of the court in overruling the foregoing exceptions and each of them and in approving the aforesaid report of the Special Master without correcting it or taking other action relative thereto in the particulars as to which appellant's exceptions were specified as above set forth.

It is the contention of appellants that the evidence was wholly insufficient to support any finding of fact to the effect that Universal funds had been traced into any properties whatever, and hence that the impressment of a trust upon the above properties was wholly erroneous.

Argument.

Since the effect of the order appealed from was merely to approve the findings, conclusions and recommendations of the Special Master, in presenting our argument we shall proceed as if we were directly attacking the Master's report. It will, of course, be understood, however, that we are at all times referring to the report and to the holdings of the Master from the standpoint of their having been adopted and approved by the court.

In the presentation of its argument in support of their own appeal appellants will rely upon the following points:

1. The Federal Equity Doctrine as to the Tracing of Trust Funds Is Controlling in This Case. That Doctrine Requires a Strict Tracing of Actual Trust Funds Into a Specific Fund or Into Specific Property.

2. Under the Federal Decisions Mere Proof of the Purchase of Properties Out of a Fund in Which Trust and Private Funds Have Been Commingled Is Insufficient to Show a Tracing of the Trust Funds Into Such Properties.

3. A Mere Showing That Trust Funds Have Gone to Swell the Assets of an Insolvent Is Insufficient to Impress a Trust Upon Properties Acquired Through the Use of the General Funds of the Insolvent With Which the Trust Funds Have Been Blended.

4. Purchases Made Out of a Commingled Fund Are Not Ipso Facto Chargeable With a Trust.

5. The Principle of In Re Oatway Has Never Been Followed in the Federal Courts to the Extent of Doing Away With the Strict Tracing Principle in Cases Dealing With the Acquisition of Real or Personal Property Out of a Commingled Fund.

In our capacity as cross-appellees in the Universal cross-appeal we will rely upon the following point:

6. If It Be Assumed That the Impressment of a Trust Upon the Properties Involved Was Proper, the Amount Thereof Could Not Exceed the Amount of the Lowest Balance in the Account Prior to a Given Purchase and Subsequent to the Last Deposit of Trust Moneys Therein, Such Low Balance to Be Computed by Deducting All Withdrawals From the Account During Each Day From the Opening Balance of Such Day, as Held by the Master and the Court.

Gist of the Controversy.

Two main questions were presented to the Special Master for decision. These were, first, whether the transfer of funds from Universal to Richfield was a conversion or misappropriation as distinguished from a series of loans or advances made upon open account; and *second,* if so, whether appellee had succeeded in tracing the misappropriated (and hence trust) funds into specific properties.

Each of the above questions was decided by the Master in the affirmative. Inasmuch as the decision as to the first point may properly be said to have been supported

by the evidence, despite a conflict, appellant does not question it here. As to the decision on the second point, however, plaintiff is unable to agree in principle with the Master's, and hence the court's, views on the subject of tracing trust funds.

We respectfully submit that the holding in this latter respect is contrary to the well-settled rule in the Federal jurisdiction, which requires one who would trace trust moneys into other forms of property to show that such trust moneys actually were employed in the acquisition of the property in question.

In lieu of requiring such an actual tracing the Master first applied to the Richfield bank account what has been variously referred to as the fiction, presumption or rule of estoppel to the effect that funds dissipated by a faithless trustee are his own, while those retained by him include the funds of the *cestui*. The Master then limited such funds of the *cestui* to the amount of the lowest balance shown in the account subsequent to the last deposit of trust moneys in order to ascertain the *cestui's* presumed balance as of the date of a particular purchase. The purchase then being made it was presumed that the moneys of the *cestui* then presumptively in the account went into the purchase and a trust was accordingly impressed upon the property acquired to the extent of such presumed balance. In no case was there any evidence that trust moneys or any part of them actually went into the purchase of the properties in question.

In view of this fact we respectfully submit that the method of tracing applied in this case is directly contrary to the requirements of actual tracing which have

been repeatedly laid down in cases of this nature. Furthermore, the history of the development of the principles applicable to the tracing of trust funds fully supports our views. It will not be disputed that it was originally the law that trust property could only be followed through a specific identification thereof and that nothing else would suffice. Thus, where specific trust moneys were commingled in a fund with private funds of the trustee the right to recover the specific moneys was lost and the *cestui* immediately became relegated to the position of a general creditor. This situation brought about the first exception to the general rule. Thereafter the *cestui* was allowed to reclaim as his own money in an amount equivalent to that theretofore delivered to him by the trustee without the necessity of a specific identification of the precise coins delivered by him. Otherwise the rules remained the same.

The next exception again related to the right to reclaim from commingled funds. In cases where the faithless trustee had dissipated part of the commingled moneys, the balance remaining in his hands, it was held proper to "presume" that the trustee had expended his own moneys first, thus permitting the *cestui* to reclaim from the balance. This was the rule of *Knatchbull v. Hallett* (1878), 13 Ch. D. 696; a rule which the Federal courts have consistently followed and applied in cases where reclamation from a fund is sought.

The next step consisted of an extension of the first exception with regard to commingled funds whereby it

was declared that a transfer of commingled trust and personal moneys from one fund of the trustee to another would warrant a tracing into the second fund.

> *Brennan v. Tillinghast*, 201 Fed. 609 (C. C. A. 6th, 1913);
>
> *In re Pacat Finance Corporation*, 27 Fed. (2d) 810 (C. C. A. 2d, 1928).

Thus, as far as the Federal courts have gone, it will have been noted that each of the foregoing exceptions relate to the matter of tracing into a commingled fund or funds of *money*. None of them relate to a tracing out of a commingled fund into parcels of real or personal property acquired therefrom, which is our case. In other words, it is our position that it always has been, and it now is the law that in order to trace trust funds into other forms of property acquired by the use of such funds, there must be proof that *actual trust moneys as distinguished from a mere hypothetical or presumptive substitute therefor were employed in the purchase or other acquisition.* We have only found one case indicating in anywise to the contrary and that is the case of *In re Oatway* (1903), 2 Ch. D. 356, which has never been followed in the United States as to this proposition and which is, as a matter of fact, contrary to the principles laid down by the Supreme Court of the United States in *Peters v. Bain*, a case which will hereinafter be discussed in detail.

At the outset it may be said that there is no great divergence of opinion in the present matter as to the general principles applicable to the tracing of trust funds. All recognize the right to trace such moneys into a specifically identified fund or into specifically identified property. All recognize the existence of a "vanishing point" beyond which such tracing may not proceed and by reason of which the asserted *cestui* must be relegated to the position of a general creditor. Recognition is also mutually given to the modern doctrine that money need not be earmarked and that a mere commingling of money in a fund will not of itself defeat the *cestui's* right to reclaim from such fund. Necessarily, there is no dispute whatever as regards the right of intervener to trace or the fact that it has traced its trust funds into the Richfield bank account in the present case. Provided the doctrine of *Knatchbull v. Hallett* (*supra*), may properly be extended to the case of a trustee *ex maleficio,* it would also be conceded that had the Richfield bank account, when taken over by the receiver, contained assets sufficient to satisfy the claim of Universal, the latter could have reclaimed its presumed moneys from the fund, subject only to the limitations of the intermediate low balance principle as declared by the Master herein in his report. This, however, is as far as the *Hallett* exception has been carried.

> *Frelinghuysen v. Nugent* (1888), 36 Fed. 229;
> *Peters v. Bain* (1889), 133 U. S. 670, *infra.*

Inasmuch as the account had been wiped out, however, prior to that time, it then became necessary that the intervener go a step farther and attempt to trace the trust funds into specific properties which had been purchased by Richfield. This, of course, necessitated a showing that there were actually trust funds *in* Richfield's possession at the time of each purchase and that they were actually used in connection therewith. No such showing was made. This being so, we find that the Master has actually held that mere proof of purchases of property out of a fund in which trust and private moneys have previously been commingled is sufficient to warrant the court in impressing a trust upon such properties to the extent of a "presumed" *cestui's* balance and without the necessity of further tracing (and this means of actually tracing), the trust moneys into such properties.

Such a contention does violence to a requirement which the Federal courts of the United States have always held paramount in such cases. This requirement is that where it is sought to follow trust moneys into a specific piece of property it must be shown that actual trust moneys (and not a mere synthetic or "presumptive" substitute therefor) went into the purchase thereof. Otherwise, the tracing is insufficient or, in other words, the "vanishing point" above referred to has been reached, for the Hallett presumption clearly has no application where a tracing from a commingled fund of *money* into acquired *property* is concerned.

Peters v. Bain, infra.

1. The Federal Equity Doctrine as to the Tracing of Trust Funds Is Controlling in This Case. That Doctrine Requires a Strict Tracing of Actual Trust Funds Into a Specific Fund or Into Specific Property.

It is settled law that the Federal courts will not follow state decisions with regard to the tracing of trust funds. Thus in *John Deere Plow Co. v. McDavid,* 137 Fed. 802 (C. C. A. 8th, 1905), arising in Missouri, it was held that a matter of tracing funds concerned "a rule of preference in equity and upon that question the Federal decisions must control in this court." Likewise, in *Beard v. Independent District,* 88 Fed. 375 (C. C. A. 8th, 1898), the Circuit Court of Appeals refused to follow the Supreme Court of Iowa, stating:

> "If such right (to follow trust funds) exists, it is not created by the statute but is based upon the general principles of law and equity applicable to the circumstances; and the rulings of the Supreme Court are not conclusive upon the latter question, nor can it be rightfully said that they constitute a rule of property which other courts are bound to follow and . . . we cannot agree with the learned judge below in holding that this consideration requires a decision of the question involved in this case in accordance with the rulings of the Supreme Court of Iowa, if the same are not in accord with the rules laid down by the Supreme Court of the United States or established by the decided weight of authority in the cases by the courts in other states."

Again we find in *In re McIntyre,* 185 Fed. 96, 108 (C. C. A. 2d, 1911), the following:

> "While the doctrine of following trust funds has been much extended in the modern decisions there has

> never been a departure in the Federal courts from the principle that there must be some identification of the property sought to be charged with the trust funds."

With this thought in mind it will be instructive at this time to refer to the leading cases under the Federal rule and to apply the principles of strict tracing laid down by them to the facts of the instant case.

2. Under the Federal Decisions Mere Proof of the Purchase of Properties Out of a Fund in Which Trust and Private Funds Have Been Commingled Is Insufficient to Show a Tracing of the Trust Funds Into Such Properties.

The above was squarely held in the case of *Peters v. Bain* (1889), 133 U. S. 670, 678, 693. In that case the partners of Bain & Bro., private bankers, became officers and directors of the Exchange National Bank of Norfolk. Shortly thereafter the firm began to absorb and to use the funds of the bank in their business until at one time their indebtedness to the bank exceeded one million dollars. By reason of this situation the bank was forced to close its doors. At the same time the Bains made an assignment for the benefit of their creditors. The resulting litigation was instituted by the receiver of the bank for the purpose of, first, setting aside the assignment, and, second, charging the property in the hands of the assignees with a trust in favor of the bank upon the theory that it had been bought with the moneys of the bank. The similarity of the facts in the case with those revealed by the evidence in the instant proceeding is manifest. Upon the trial it developed that in certain cases properties had been

bought by the Bains with moneys taken directly from the bank and immediately applied for that purpose. As to this class the trust was declared subject to the rights of *bona fide* purchasers, no commingling of funds having taken place. In other cases properties were bought by the Bains with commingled funds which had been augmented by moneys received from the bank as well as from other sources and as to this class the trust was disallowed because of the inability of the receiver to establish that these purchases had actually been made with trust funds. It will immediately be perceived that this last situation was identical with that presented by the evidence in the instant case.

The opinion in the Circuit Court in the *Bain* case was written by Chief Justice Waite of the Supreme Court sitting on circuit. His decision was later affirmed by the Supreme Court in an opinion written by the then Chief Justice Fuller, who therein stated that the clear opinion of the former Chief Justice had minimized the labors of the Supreme Court in deciding the appeal. In view of the fact that the opinions of two former chief justices of the Supreme Court uphold the contention which we are making in the instant case, we take the liberty of quoting from each.

From Opinion of Chief Justice Waite.

"The money received by the firm from the bank was generally mingled with that which was got from other sources, and it has been impossible to trace it directly into property now in the hands of the assignees, except in the following cases:

(Here appears a schedule of some 13 items of property constituting the first class of property referred to in the ensuing paragraphs.)

"1. As to the trust resulting to the bank by reason of the wrongful and unlawful use of its funds by its officers in the purchase of property for the firm or the several members thereof, this branch of the case divides itself into two parts, the first relating to property which was purchased with moneys that can be identified as belonging to the bank; and, second, to that which was bought and paid for by the firm out of the general mass of moneys in their possession and which may or may not have been made up in part of what had been wrongfully taken from the bank.

"As to the first of these classes of property we entertain no doubt that the trust exists, and that it may be enforced by the receiver unless the assignees of Bain & Bro. occupy the position of *bona fide* purchasers for a valuable consideration without notice. . . . The evidence shows beyond doubt that the affairs of the bank were managed almost exclusively by the members of the firm. The funds of the bank were under the immediate control of its officers and agents, and consequently as its trustees. These funds were converted by them regardless of their duty as trustees into this particular property, which still exists in specie. *No money was used in these purchases other than such as was taken directly from the bank for that purpose.* Under these circumstances the property stands in the place of the money used, and it might have been reclaimed by the bank at its election any time before the rights of innocent third parties intervened. This is elementary. The receiver succeeded to the rights of the bank in this particular.

"The property in the second class, however, occupies a different position. There the purchases were made with moneys that cannot be identified as be-

longing to the bank. The payments were all, so far as now appears, from the general fund then in the possession and under the control of the firm. Some of the money of the bank may have gone into this fund, but it was not distinguishable from the rest. The mixture of the money of the bank with the money of the firm did not make the bank the owner of the whole. All the bank could in any event claim would be the right to draw out of the general mass of money, *so long as it remained money,* an amount equal to that which had been wrongfully taken from its own possession and put there. Purchases made and paid for out of the general mass cannot be claimed by the bank, *unless it is shown that its own moneys then in the fund were appropriated for that purpose.* Nothing of the kind has been attempted here, and it has not even been shown that when the property in this class was purchased, the firm had in its possession any of the moneys of the bank *that could be reclaimed in specie.* To give a *cestui que* trust the benefit of purchases by his trustees, it must be satisfactorily shown that they were *actually made* with the trust funds." (Italics ours.) (pp. 677, 678, 679.)

From the Opinion of Chief Justice Fuller.

"The receiver assigns for error that the Circuit Court held that he was entitled to a surrender of such of the property which it was found had 'actually been purchased with the moneys of the bank as he elects to take, but of no other.' In other words, it is insisted that the receiver is entitled to a charge upon the entire mass of the estate, with priority over the other creditors of Bain & Bro.

It was said by Mr. Justice Bradley in Frelinghuysen v. Nugent, 34 Fed. Rep. 229, 239: 'Formerly the equitable right of following misapplied money or other property into the hands of the parties receiving it depended upon the ability of identifying it; the equity attaching only to the very property misapplied. This right was first extended to the proceeds of the property, namely, to that which was procured in place of it by exchange, purchase or sale. But if it became confused with other property of the same kind, so as not to be distinguishable, without any fault on the part of the possessor, the equity was lost. Finally, however, it has been held as the better doctrine that confusion does not destroy the equity entirely, but converts it into a charge upon the entire mass, giving to the party injured by the unlawful diversion a priority of right over the other creditors of the possessor. *This is as far as the rule has been carried.* The difficulty of sustaining the claim in the present case is, that it does not appear that the goods claimed—that is to say, the stock on hand, finished and unfinished—were either in whole or in part the proceeds of any money unlawfully abstracted from the bank.' The same difficulty presents itself here, and while the rule laid down by Mr. Justice Bradley has been recognized and applied by this court, National Bank v. Insurance Company, 104 U. S. 54, 67, and cases cited, yet, as stated by the Chief Justice, 'purchases made and paid for out of the general mass cannot be claimed by the bank *unless it is shown that its own moneys then in the fund were appropriated for that purpose.*' And this the evidence fails to establish as to any other property than that designated in the decree." (Italics ours.) (Pp. 693, 694.)

It will be seen that the foregoing case lays down some very definite principles and as far as the instant case is concerned some exceedingly controlling ones. Due to the fact that in that case some of the properties could be traced while the balance could not, we are afforded an excellent guide as to the principles governing the tracing of trust funds into real property. These principles may be enumerated as follows:

(a) *The requirement that trust funds be traced into specific property in order that a trust be imposed upon the latter is met by a showing that specific trust moneys not commingled with private funds were actually used in the acquisition of the property.*

("No money was used in *these* purchases other than such as was taken directly from the bank for that purpose.")

(b) *Such requirement is not met by a showing of purchases made out of a commingled fund which had been augmented at some prior time through the infusion of trust moneys.*

("The money received by the firm from the bank was generally mingled with that which was got from other sources and it has been impossible to trace it *directly* into property now in the hands of the assignees" etc.)

(c) *The right to reclaim trust moneys out of the balance remaining in a commingled fund, under the Hallett presumption, in no sense relieves the cestui of the necessity of actually tracing his trust moneys into properties acquired out of the commingled fund.*

("All the bank could in any event claim would be the right to draw out of the general mass of money *so long as it remained money* an amount equal to that which had been taken from its own possession and put there.")

(d) *The right to reclaim out of a commingled fund conferred by the Hallett presumption in no sense extends to purchases made out of such fund. In such a case the claimant must show, in order to impress a trust upon the acquired property, that the same was actually purchased with trust moneys.*

("Nothing of the kind has been attempted here and it has not even been shown that when the properties in this class were purchased, the firm had in its possession any of the moneys of the bank *that could be reclaimed in specie.* To give a *cestui que* trust the benefit of purchases by the trustees it must be satisfactorily shown that they were *actually made* with the trust fund.")

(e) *Mere proof that property has been acquired through payments made out of a commingled fund is insufficient to establish that the cestui's own money, as distinguished from that of the trustee, has been used to make such purchase.* (*Id.*)

We submit that the above case is unanswerable as to each of the above propositions.

The Master, however, attempted to distinguish the case on the ground that, as literally appears from the opinion, the books of the bank and of the partnership were in such a chaotic condition that the principle of "low balance"

tracing of the commingled trust moneys could not be applied. Obviously then the Master assumed that if such a tracing had been possible a contrary result would have been reached by the Supreme Court. We respectfully submit that the case itself negatives the learned Master's theory. It also negatives the basic proposition upon which the Master's ultimate holding is based and to which he cites *Peters v. Bain* as authority, namely, that where a mixed fund is traced into property the property is but a substituted form of the mixed fund. With all respect we submit that *Peters v. Bain* holds exactly to the contrary. Let us state a few pertinent expressions of the respective opinions of the two Chief Justices:

> 1. "The mixture of the money of the bank with the money of the firm did not make the bank the owner of the whole."

This is unquestionably a proposition which would be true whether there was a "low balance" tracing or not.

> 2. "All the bank could in any event claim would be the right to draw out of the general mass of money, *so long as it remained money,* an amount equal to that which had been wrongfully taken from its own possession and put there." (Italics ours.)

Here is both a recognition and a limitation upon the operation of the exception to the general rule of actual tracing laid down by the *Hallett* case.

Paraphrasing this language to fit our facts, we find that all Universal could claim in any event (a commingled fund being proven) would be the right to draw out of the general mass of money, *so long as it remained money,* an amount equal to that which had been wrongfully taken from its possession and put there. This is the only and

the utmost effect which may be attributed to the *Hallett* doctrine, whether it be regarded as an estoppel upon the trustee (which was the view taken by the Master) or as a fiction or as a presumption. In any case, it only operates as a *modus operandi* whereby the defrauded *cestui* may subject to his claim the balance of a theretofore commingled fund remaining in the hands of the trustee.

> "This is as far as the rule has been carried."
>
> *Frelinghuysen v. Nugent, supra.*

Hence, when it comes to purchases of property made by the trustee out of moneys in his possession, whether there has been a comminglement or not, the exception has no application, for it, together with its rule of estoppel, impinges against and yields to the general rule requiring a strict and actual tracing of the trust moneys.

> 3. ". . . it has not even been shown that when the property in this class was purchased the firm had in its possession any of the moneys of the bank that could be reclaimed in specie."

This language indicates that even if such a showing had been made there would still remain the necessity of proof that trust moneys had actually gone into the purchase of the property which is our problem here. This is made manifest by the following:

> 4. "To give a *cestui que* trust the benefit of purchases by his trustees, it must be satisfactorily shown that they were *actually* made with the trust funds." (Italics ours.)

In other words, it is quite clear from the language above quoted that even though a showing be made sufficient to warrant a reclamation from a fund as a fund, it

by no means follows that evidence of a purchase paid for by the moneys at such time in the fund is sufficient to warrant a finding that trust funds actually went into the property.

This is so by reason of the limitations upon the exception to the general rule which permits the reclamation from a fund only of a substituted equivalent for the trust moneys originally deposited therein. The trustee, we may say, is estopped to deny that the moneys held by him include the trust moneys. This estoppel, fiction or presumption, whatever it may be, has no operation where property is acquired by the trustee through the use of funds which, as a matter of fact, may or may not be said to include those previously entrusted to him. In such a case the general rule, rather than the exception, applies, and one who would prevail as against the general creditors of the faithless trustee must prove, as a fact, that trust moneys actually were used. There is no presumption, fiction or estoppel which is operative in such a case. The matter is purely and simply one of proof of a fact without reference to the artificial aids which, by means of the Hallett rule, may be resorted to when reclamation from a commingled fund is sought. In the instant case, we may concede that the tracing was such that at the time of any of the purchases a reclamation in specie from the fund might have been had. When it came to purchases made from the fund, however, it was incumbent upon intervener to show that trust funds *actually* and not "presumptively" or by reason of the exercise of any fiction or estoppel, went into the property acquired. There is no pretense that such a showing was made. As a matter of fact, it was practically an every day occurrence for the withdrawals from

the Richfield bank account to exceed the amount of the last prior deposit of trust moneys. In this connection the evidence indicated that approximately $81,000,000.00 passed through the account during the period of the dealings between the two companies. [Tr. p. 98.]

Thus we find that the Master applied the rule of estoppel which is applicable only where an attempt is made to reclaim from a specific fund to a series of purchases of property where, we respectfully submit, a showing of actual and not synthetic use of the trust funds was requisite. From the standpoint of a tracing into real property, all that the record reveals is a series of purchases made from a fund in which there previously had been infused both trust and private moneys with no evidence whatever to show whether any of the trust moneys actually went into the purchase of any of the parcels of property acquired. Likewise, if we eliminate the effect of the Hallett rule there was no evidence whatever to show that there were actually any trust moneys whatever in the fund at the time of the making of any of the purchases in question.

The language used in the opinion of Chief Justice Fuller in *Peters v. Bain* likewise fully supports our contention. His citing of the case of *Frelinghuysen v. Nugent* to the point that while a confusion (or comminglement) does not destroy the equity, the result being a charge upon the entire mass, *but that this is as far as the rule has been carried,* completely illustrates the extent to which the Hallett fiction may be employed. Here, we respectfully submit, the Master, and hence the court, has carried it to a length wholly unsanctioned by the law as declared by the Supreme Court. He has sustained an asserted trac-

ing into property acquired through the use of a commingled fund upon evidence which would only have warranted a reclamation in specie from the fund itself. In the latter case, due to the exception applicable solely thereto, an actual tracing of the trust moneys is not required. In the former case an actual tracing is and always has been required and it is undisputed that the evidence in this case shows none whatever. With all respect, the conclusion of the Master that the acquired property stands as the trust property in a substituted form wholly begs the question. Before this can be said the trust moneys must be shown to have been used in its acquisition. No such showing was made.

Another decision of the Supreme Court which in principle negatives the Master's theory is that of *Schuyler v. Littlefield* (1913), 232 U. S. 707, 712. In that case Brown & Co. obtained from plaintiff by fraud certain Interborough stock of a value of $9600.00. That stock, together with others aggregating in value $289,600.00, was sold by Brown & Co. to Miller, who paid for it with two checks, one for $266,600.00 and the other for $23,-000.00. Brown & Co. failed. Their check to plaintiff for the Interborough was denied payment and plaintiff then sought either to reclaim from the Brown & Co. bank account or to impress a trust upon certain stocks asserted by plaintiff to have been acquired from that bank account with the proceeds of the Miller checks. Both forms of relief were denied.

As to the claimed right to impress a trust on the stocks acquired, the Supreme Court held that not only was there doubt as to when the Miller checks were deposited in the Brown & Co. account (as it was closed at or about

the time of such deposits) but also that even if it be deemed that the checks had been deposited so as to have been used prior to the closing of the account, no sufficient showing had been made as to the *particular use* to which the proceeds of these checks had been devoted. We quote from the opinion as follows:

> "The appellants, however, presented their case in a double aspect. They contended that even if the trust fund of $9,600 was checked out of the bank they are able to trace the fund into stocks that subsequently came into the hands of the Trustee in Bankruptcy. This was based on the claim that out of the proceeds of the Miller checks, Brown & Co. had paid notes due to the bank and thereby released collateral which ultimately came into the possession of the Trustee.
>
> But the record fails to show when the $266,600 was deposited and it also fails to show with the *requisite certainty* the particular use made by Brown & Co. of that money. The banking transactions on August 24th involved several millions of dollars. Money was deposited by Brown & Co. in the bank and money was borrowed by Brown & Co. from the bank. Part of the loans were deposited to their bank account and a part, represented by cashier's checks, did not appear in that account. Money was paid by Brown & Co. to outsiders and to the bank. Payments to the bank were made on accounts of notes, some of which represented loans appearing in the deposit account, and others represented loans which had not been so entered. Some of the loans were secured and others were unsecured, and whether the money received from Miller (which included the trust fund of $9,600), was used to pay the secured or unsecured loans *does not appear with certainty.*

It would serve no useful purpose to make a detailed statement of the testimony. The evidence has been fully discussed by the Court of Appeals (193 Fed. Rep. 24-33) in considering this claim of appellants along with that of several other parties seeking, on somewhat similar facts, to trace trust funds into the bank and thence into collateral which ultimately came into the hands of the Trustee. All these claims were disallowed because of the failure to make the requisite proof. Our investigation of the facts leads us to the same conclusion so far as concerns the appellants' claim. They were practically asserting title to $9,600 said to have been traced into stock in the possession of the Trustee. Like all other persons similarly situated, they were under the burden of proving their title. If they were unable to carry the burden of identifying the fund as representing the proceeds of their Interborough stock their claim must fail. If their evidence left the matter of identification in doubt the doubt must be resolved in favor of the Trustee, who represents all of the creditors of Brown & Co., some of whom appear to have suffered in the same way. Like them the appellants must be remitted to the general fund." (Italics ours.)

The above holding is significant when we consider the stress laid by the Supreme Court as to the necessity of showing with requisite certainty, the particular use to which the asserted trust moneys had been devoted.

Appellee has heretofore attempted to distinguish *Schuyler v. Littlefield* and as well the decision of the case

in the Circuit Court of Appeals (sub nom *in re* Brown, 193 Fed. 30, C. C. A. 2nd, 1912) by asserting in effect that inasmuch as *all* of the claimants were *cestuis que trustent* "a higher degree of proof is required because a claimant must show some reason why he should be entitled to a preference over one standing in the same position as he is." This assumption was entirely gratuitous and was advanced wholly without citation of authority to support it. True, there were several trust claimants in the fund which arose upon the unhappy demise of Brown & Co. (see *In re A. O. Brown & Co.,* 193 Fed. 24), but this did not mean that Brown & Co. had no general creditors. That the contrary was the case is made apparent by the very language in *Schuyler v. Littlefield,* where, in laying down a rule which has direct application to the instant case, the Supreme Court stated:

> "If their evidence left the matter in doubt the doubt must be resolved in favor of the trustee who represents *all* of the creditors of Brown & Co., *some* of whom appear to have suffered in the same way."

Moreover, it is quite apparent from reading any or all of the three decisions dealing with the misfortunes of Brown & Co. that neither the Supreme Court nor the Circuit Court of Appeals based their holding of insufficient tracing upon any such theory as that advanced by intervener. In any case and irrespective of whether others occupy the same position, one seeking to establish a trust must trace the property or its proceeds. No other conclusion may be drawn when we find precisely the same rule

of tracing followed in the Brown & Co. cases as had previously been declared in *Peters v. Bain,* where there did not appear to have been any trust claimants other than the bank receiver. It follows, therefore, that in addition to the principles for which the *Bain* case stands as authority, we are indebted to *Schuyler v. Littlefield* for the following:

(f) *In order that a claimant establish a trust against property purchased or otherwise acquired out of a commingled fund through the asserted use of trust funds, the burden is upon the claimant to prove with certainty that his money actually went into property so acquired.*

(g) *Even if it be shown that a deposit which actually included trust moneys was made in an active bank account, mere proof of the acquisition of property through withdrawals from that account is insufficient to trace the trust moneys into the property so acquired.*

This last principle is especially applicable to the facts of the instant case. It will be recalled that enormous sums were daily deposited in and withdrawn from the Richfield bank account during the period involved herein.

We, therefore, respectfully submit that the evidence merely reveals that the general assets coming into the hands of the receiver were indirectly augmented by the amounts received from Universal, and that there was in no sense any actual tracing of such amounts into any specific properties. It has been universally held that such a showing is insufficient.

3. A Mere Showing That Trust Funds Have Gone to Swell the Assets of an Insolvent Is Insufficient to Impress a Trust Upon Properties Acquired Through the Use of the General Funds of the Insolvent With Which the Trust Funds Have Been Blended.

The above rule is universally declared by the federal and most of the state decisions. Thus in *Board of Commissioners v. Strawn,* 157 Fed. 49 (C. C. A. 6, 1907) we find the following statement (page 54):

> "But aside from this view of the evidence, the claim to a general charge upon any and all property acquired by the bank, through the use of the general funds of the bank with which this trust fund had been blended, is not supported by the weight of authority, nor do the cases decided by this court go so far. That the misuse of this trust fund has gone to swell, in one form or another, the general assets of the bank is not enough to charge the whole with a lien, will not be seriously contested. The cases which deny such a contention are numerous."

The above principle is reiterated in *Empire State Surety Co. v. Carroll County,* 194 Fed. 593 (C. C. A. 8, 1912), in the following language (page 604):

> "It is indispensable to the maintenance by a *cestui que trust* of a claim to preferential payment by a receiver out of the proceeds of the estate of an insolvent that clear proof be made that the trust property or its proceeds went into a specific fund or into a specific identified piece of property which came to the hands of the receiver and then the claim can be sustained to that fund or property only and only to the extent that the trust property or its proceeds went into it. It is not

sufficient to prove that the trust property or its proceeds went into the general assets of the insolvent estate and increased the amount and the value thereof which came to the hands of the receiver. Peters v. Bain, 133 U. S. 670, 693, 694, 10 Sup. Ct. 354, 33 L. Ed. 696; Spokane County v. First Nat. Bank, 68 Fed. 979, 982, 16 C. C. A. 81, 84; Board of Com'rs. v. Patterson (C. C.) 149 Fed. 229; Frelinghuysen v. Nugent (C. C.) 36 Fed. 229, 239; Board of Com'rs. v. Strawn, 157 Fed. 49, 51, 84 C. C. A. 553, 555, 15 L. R. A. (N. S.) 1100; Lowe v. Jones, 192 Mass. 94, 101, 78 N. E. 402, 6 L. R. A. (N. S.) 487, 116 Am. St. Rep. 225, 7 Ann. Cas. 551; Cherry v. Territory, 17 Okl. 213, 89 Pac. 190; St. Louis Brewing Ass'n. v. Austin, 100 Ala. 313, 13 South. 908; Little v. Chadwick, 151 Mass. 109, 23 N. E. 1005, 7 L. R. A. 570; Howard v. Fay, 138 Mass. 104; Attorney General v. Brigham, 142 Mass. 248, 7 N. E. 851; Erie Ry. Co. v. Dial, 140 Fed. 689, 72 C. C. A. 183; Ferchen v. Arndt, 26 Or. 121, 37 Pac. 161, 29 L. R. A. 664, 46 Am. St. Rep. 603; Blake v. State Savings Bank, 12 Wash. 619, 41 Pac. 909, 910; *In re* North River Bank, 60 Hun. 91, 14 N. Y. Supp. 261; Williams v. Van Norden Trust Co., 104 App. Div. 251, 257, 93 N. Y. Supp. 821; Bishop v. Mahoney, 70 Minn. 238, 73 N. W. 6; Nonotuck Silk Co. v. Flanders, 87 Wis. 237, 58 N. W. 383; Burnham v. Barth, 89 Wis. 362, 366, 62 N. W. 96; Bradley v. Chesebrough, 111 Iowa, 126, 82 N. W. 472; Lebanon Trust & Safe Deposit Bank's Assigned Estate, 166 Pa. 622, 31 Atl. 334; Marquette Fire Com'rs. v. Wilkinson, 119 Mich. 655, 670, 78 N. W. 893, 44 L. R. A. 493; Hauk v. Van Ingen, 196 Ill. 20, 39, 63 N. E. 705; Ellicott v. Kuhl, 60 N. J. Eq. 333, 46 Atl. 945; Ober v. Cochran, 118 Ga. 396, 45 S. E. 382, 98 Am. St. Rep. 118; *In re Mulligan* (D. C.) 116 Fed. 715,

717, 718; Holmes v. Gilman, 138 N. Y. 369, 376, 34 N. E. 205, 20 L. R. A. 566, 34 Am. St. Rep. 463; *In re Hicks*, 170 N. Y. 195, 198, 63 N. E. 276."

The case of *In re Brown*, 193 Fed. 24 (C. C. A. 2, 1912), to which we have heretofore made reference, is interesting in this connection. Not only does it negative the theory that a superior equity does away with the necessity of proof of the tracing but it also places the burden of proof where it belongs, which is to say, upon the claimant. It also follows the main principle under discussion with reference to proof of a mere augmentation of assets being insufficient. We quote (page 28):

> "As we have seen, the Hanover Bank had in its possession various surpluses of collaterals above the amount of the several notes for which such collateral was pledged, *some of these collaterals were paid for by checks drawn on the Hanover Bank and paid* on the 24th, and it is contended that a lien for the trust funds is established against the surpluses of collaterals so purchased. *But there is nothing to trace claimant's money into any particular stocks or bonds, or into the collateral put up against any particular loan.*
>
> "It was said in Smith v. Mottley, 150 Fed. 268, 80 C. C. A. 154, that:
>
> "'In the absence of proof to the contrary, the reception of the funds being so near to the assignment by the bank, it may be presumed that the assets which came to the hands of the trustee were augmented by the proceeds of the check'—which check in that case was the thing converted.
>
> "Thus baldly stated the quotation might seem to support the theory that the beneficiary would have a lien on property which came to the trustee because

the bankrupts, had they not misused the trust fund, would have had to borrow that additional sum from their banks on the collateral they had with them covering their various notes, and therefore the banks would have paid themselves out of such collateral, and the trustee in bankruptcy would not have obtained so much from them. The same court which decided Smith v. Mottley, however, subsequently held, in Board of Commissioners v. Strawn, 157 Fed. 49, 84 C. C. A. 553, 15 L. R. A. (N. S.) 1100, that *the mere fact that the misuse of a trust fund has gone to swell, in one form or another, the general assets of a bankrupt, is not enough to charge a lien on such assets;* and that, to impress a trust upon the property of a tort-feasor who has used the trust fund in his private affairs, *it must be traced in its original shape or substituted form.* We fully concur in this statement of the law. No doubt the individual whose property has been converted has a high equity and is entitled to certain well-settled presumptions; but we cannot assent to the proposition that he may trace his money into any specific fund or security *merely by inferences based on presumptions* without substantive testimony to sustain them. *The burden of proof is on the claimant at the outset; it rests upon him at the close of the case.* If he has not, then, upon the whole proof, made clear the final resting place of his converted property or its substitute, he cannot sustain his claim." (Italics ours.)

The facts to which the foregoing principles were applied are especially relevant here. The proceeds from the claimant's converted stock, $2037.50, had been deposited in the account in the Hanover Bank, thus paralleling our facts. Prior to the closing of the account certain collaterals were purchased therefrom, again paralleling our

facts. Moreover it was assumed in support of the conclusion of the trial court that the "low balance" of the account exceeded the amount of the trust moneys up to the time of the purchase of the collateral. Upon this showing, if the Master's position is correct, a trust should have been declared upon purchases from the bank account prior to the closing thereof, not exceeding the above mentioned sum. On the contrary, however, the court concurred with the holding of the District Court that any proceeds of claimant's stock which might have been in the account were dissipated by the certification of a check which wiped out the account on the day *after* the collaterals were acquired and that the proceeds could be traced no further for this reason.

It will be seen that the above case merely follows the principles of *Peters v. Bain. So long as the commingled fund remains money* the claimant may seek recovery against the residue subject to low balance principles and in accordance with the fiction of *Knatchbull v. Hallett.* Where, however, a claimant merely shows purchases out of a commingled fund which has later been dissipated, he has merely shown an augmentation of assets without the necessary adjunct of a tracing into the property acquired.

In this connection appellee has heretofore cited *Schumacher v. Harriett*, 52 Fed. (2d) 817 (C. C. A. 4, 1931) and *Ellerbe v. Studebaker Corp.*, 21 Fed. (2d) 993 (C. C. A. 4, 1927) to the effect that trust funds may be recovered from a receiver if they have gone to augment the assets passing through the receiver's hands. This was a rather left-handed way of stating the holdings in these two cases. Their true effect is perhaps epi-

tomized by the following quotations from the *Schumacher* case (page 818, page 819):

> "The rule is well settled that where property or funds which are the subject of a trust are used by a bank in such way as merely to decrease its liabilities and not to augment its assests, no charge upon the assets arises in favor of the *cestui que trust.* Ellerbe v. Studebaker Corporation of America (C. C. A. 4th) 21 F. (2d) 993; First National Bank of Ventura v. Williams (D. C.) 15 F. (2d) 585; City Bank v. Blackmore (C. C. A. 6th) 75 F. 771.
>
> * * * * * * * *
>
> "As the fund upon which the trust is asserted in this case is the fund of cash and cash items which passed into the hands of the receiver, the question in the case is whether the $8,500 of plaintiff has been traced into that fund; for it is settled that *it is not sufficient merely to prove that the trust property went into the general estate and increased the amount and value thereof which came into the hands of the receiver.* Empire State Surety Co. v. Carroll County, *supra* (C. C. A.) 194 F. 593 at page 604, and cases there cited." (Italics ours.)

So considered, it will be seen that the two decisions in question really stand for the proposition that where the trust funds have been used to decrease liabilities a trust may not be declared upon the general assets. On the other hand where the trust funds have been used to augment the assets (cash) and can be traced into those assets, a recovery against the fund will be allowed. We do not quarrel with this proposition which in no way affects the principle that strict tracing is required where it is sought

to fasten a trust upon real property acquired out of commingled funds.

Since appellee still asserts, we assume, that purchases made out of a commingled fund are *ipso facto* chargeable with the same claim which might have been asserted against the fund itself, it behooves us to analyze the decisions which it has heretofore cited to this point.

4. Purchases Made Out of a Commingled Fund Are Not Ipso Facto Chargeable With a Trust.

The following federal cases were cited by appellee in support of the proposition that "if funds misappropriated by a trustee are commingled with his own funds, property in which the commingled funds are invested is subject to a lien in favor of the *cestui*."

(1) *In re J. M. Acheson Co.,* 170 Fed. 427, 429, (C. C. A. 9, 1909).

In this case the court was dealing with the sufficiency of a petition for a preferred claim in bankruptcy which had been disallowed. The petition directly alleged that the trust funds had been used, among other things, in acquiring assets which had come into the hands of the trustee. Inasmuch as the petition directly charged the use of the trust funds in acquiring the property in question it was clearly sufficient. The pronouncements of the opinion with regard to the matter of proof to be made at subsequent hearings also support our position here. The decision states that

> "The owner must assume the burden of ascertaining and tracing the trust funds, showing that the assets which have come into the hands of the trustees

> have been *directly added to or benefited* by an amount of money realized from the sales of the specific goods held in trust," (Italics ours)

which is eminently correct. Such a showing would, of course, necessitate a tracing of the trust funds into the goods or property coming into the hands of the trustee upon his appointment. Then, says the opinion, the burden devolves upon the trustee to distinguish between "what is his and that of the *cestui que trust*." In other words, if the claimant makes a *prima facie* showing of tracing the moneys into the goods, then the burden is on the trustee, if he can, to repudiate such showing. Obviously, if no proof were offered by the trustee in such a situation the claimant would be entitled to a decision in his favor. It will readily be seen, however, that in the instant case appellee never reached a position which necessitated such rebuttal evidence, for it made no attempt whatever to trace from the commingled fund into the acquired property and thus never reached a point where it could rest its case and be relieved of the burden of going forward.

It will be realized immediately that appellee seeks to avail itself of the rule with regard to the shifting of the burden of going forward declared in the case last cited without in the least heeding the requirement that before the rule may be deemed applicable the claimant must have made a *prima facie* showing of a tracing. It takes the position that upon a mere showing that trust funds were commingled with the general funds of Richfield the burden immediately devolved upon those resisting the claim to show that purchases out of the commingled fund were *not* made with trust funds. In this way it ingeniously seeks to avoid the troublesome matter

of tracing the trust funds into the assets coming to the hands of the receiver which is, under the very case it cites, a burden which it and it alone must assume. Were it merely seeking to reclaim from the commingled fund then a *prima facie* showing would be made upon mere proof of the commminglement of moneys, as the case of *American Surety Co. v. Jackson,* 24 Fed. (2d) 768 (C. C. A. 9, 1928) cited by it and later discussed herein clearly shows. In a situation of that sort the presumption of the *Hallett* case comes into play and it will be presumed that the balance remaining in the fund is composed of trust moneys unless (and here the burden is upon the trustee) it can be shown that the trust moneys had actually been dissipated. We have no such situation in the present case. It would only be paralleled by the facts here if appellee had actually made a showing that actual trust moneys had been used to purchase the acquired properties. This showing having been made, it would then have devolved upon those resisting the claim to controvert such showing if they could, but it will be clearly perceived that appellee rested far short of such a *prima facie* position as this.

(2) *City of Spokane v. First National Bank of Spokane,* 68 Fed. 982 (C. C. A. 9, 1895).

Here again the sufficiency of a pleading was under consideration. The court construed the "averments of the bill to distinctly allege that the assets which came into the hands of the receiver were purchased by the bank with the city's money." Manifestly the bill was sufficient. Whether or not the city would have been able to trace the trust fund into the acquired assets by proof was quite another matter which the court quite properly refrained

from passing upon. It is significant that in the companion case of *Spokane County v. First National Bank,* 68 Fed. 979, where the averments which form the basis of the holding in the city's case were omitted, the court stated, in affirming the decree of dismissal on demurrer (page 982):

> "Both the settled principles of equity and the weight of authority sustain the view that the plaintiff's right to establish his trust and recover his fund must depend upon his ability to prove that his property is in its original or a substituted form in the hands of the defendant."

Kemp v. Elmer Co., 56 Fed. (2d) 657 (D. C. S. D. Cal., 1932).

The opinion in this case concerned the admissibility of certain evidence which, the court held, indicated that all of the assets of the Elmer Company consisted of moneys or the fruits thereof embezzled by Beesemyer from the Guaranty Building and Loan Association. Since, under these facts, all of the assets of the Elmer Company had been indisputably acquired with trust moneys the tracing was complete. There was no question of purchases out of a commingled fund in the case.

Equitable Trust Co. v. Conn. Brass & Manuf. Co., 10 Fed. (2d) 1913 (C. C. A. 2, 1926).

In this action the United States had delivered some 2,000,000 pounds of raw copper to defendant which had intermingled it with its own metal. Some 700,000 pounds of the commingled copper came into the possession of the defendant's receiver. The court held quite properly that the United States was entitled to withdraw its equivalent amount of copper from the commingled mass. This situa-

tion would be paralleled in our case if appellee were seeking to reclaim from a commingled fund coming into the hands of the receiver rather than attempting to trace *out* of such a fund subsequently dissipated.

> *Southern Cotton Oil Co. v. Elliotte,* 218 Fed. 567, (C. C. A. 6, 1914).

The bankrupt had borrowed money from the claimant for the express purpose of buying cotton seed and shipping it to plaintiff. At the time of the bankruptcy certain seed purchased by the bankrupt had been delivered to the claimant's warehouse. Although it appeared that some of this seed had been obtained otherwise than through the use of the claimant's money, the court held primarily that the evidence was sufficient to fix the general character of the mass as having been purchased directly with claimant's funds, laying some stress upon the doctrine of tortious confusion. The case is, of course, easily distinguishable. Where the asserted trustee agrees to divert moneys received to a particular use and it is later ascertained that the trustee has diverted moneys to such use, a presumption the converse of that in the *Hallett* case would naturally seem to arise that the *cestui's* moneys and not the trustee's were used therefor. This situation could only have arisen in our case if Richfield had specifically agreed to use the Universal moneys for the purpose of acquiring the various properties involved. Under such an agreement Richfield would have had considerable difficulty in establishing that the purchases had been made

for its own account rather than in performance of its trust. The case is of no assistance here by reason of the divergent nature of its underlying facts.

> *Smith v. Town of Au Gres,* 150 Fed. 258 (C. C. A. 6, 1906).

In this case the bankrupt openly admitted that he had used moneys of the township to the extent of $4400.00 in his own private business. The admissions were held competent and hence the evidence clearly showed a tracing into the assets which came into the hands of the trustee. For this reason the case begs the question under discussion here.

The same court which decided the *Au Gres* case later distinguished it not only upon this ground but upon the further ground that cases involving stocks of merchandise are *sui generis* as compared with those involving an attempt to impress a trust upon separate and distinct pieces of property (in that case, distinct pieces of commercial paper). We quote from *Board of Commissioners v. Strawn, supra* (page 57):

> "In the Au Gres case *it was shown* that a township treasurer had used the public funds in his hands in buying additional merchandise, and adding the same to his stock as a general merchant. He became bankrupt, and this stock of merchandise thus augmented went into the possession of the trustee. The particular items which had been paid for and added to the general stock were not ascertainable, but this court held that the misappropriated trust fund, having been traced into the general stock, constituted a prior lien and charge upon the stock as a unit. This case proceeds upon the theory that a stock of merchandise constitutes a subject which is capable of

> being sold or mortgaged as an entirety, and in the latter case the mortgage is not invalid if it provides for a continuance of the business, merchandise added from time to time to take the place of that sold passing under the mortgage. It is quite distinguishable from the case at bar, where it is sought to fasten a trust fund upon hundreds of distinct pieces of commercial paper made by many different persons and acquired at different times, because it is probable that some of such bills or notes were acquired with the general funds of the bank with which had been mingled some part of complainants' tax deposits." (Italics ours.)

In addition to the foregoing it is interesting to note that in the *Strawn* opinion (page 54) the court characterizes the *Au Gres* case as one of the

> "cases decided by this court, which recognize that the mere misapplication of a trust fund does not create a general lien upon the tort-feasor's estate. In other courts, the question has been presented more squarely for a decision, and supports the rule that an identification of the fund itself, or *a tracing into some specific property,* is essential to reach the property of a wrongdoer, either in the hands of an assignee, trustee, receiver, or under a lien fastened by a creditor. Peters v. Bain," etc. (Italics ours.)

Appellee also cited *American Surety Company v. Jackson,* 24 Fed. (2d) 758 (C. C. A. 9, 1928) in support of its contention that while the burden is on the *cestui* to trace the funds and establish his claim thereto by clear and satisfactory proof nevertheless the burden shifts, once the receipt of trust funds by the asserted trustee is shown. As we have pointed out above, this contention would be

well founded were appellee going no further than to assert its rights as against the fund into which the money is traced, which was the precise situation in the *Jackson* case. The court in that case merely held that the Hallett doctrine was a mere fiction, that it had been approved and followed "in many subsequent cases when the trust fund has consisted of moneys on deposit," and that in such a case to avoid the application of the fiction the trustee must show, if he can, that the trust moneys were dissipated so as not to be deemed to be in the fund remaining. We have no quarrel with this principle if limited to its proper scope. Where, however, it is sought to impress a trust upon properties purchased *out* of a fund, the logic of this very principle demands that the *cestui* then trace, if he can, the trust funds into the acquired property. Then, and not until then, is the trustee called upon to combat this showing precisely as stated in *In re J. M. Acheson & Co., supra.*

From the combined effect of these cases, both decided in the 9th Circuit, we may draw the following principle with regard to the matter of burden of going forward.

> (h) *In applying the principle that the claimant must trace the asserted trust fund and establish his claim to the same or its proceeds by clear and satisfactory proof, the burden of going forward never shifts until the claimant has actually introduced evidence which, if not controverted, would support a finding that the trust res in whole or in part actually went into the fund or specific piece of property sought to be charged.*

From *Peters v. Bain* and kindred cases heretofore cited by us the following corollary to the above we submit is correct:

> (i) *A mere showing that purchases of property have been made out of a fund in which prior thereto trust funds had been commingled with funds of the asserted trustee, is not sufficient to support a finding that the trust res in whole or in part actually went into the properties sought to be charged. Hence, in such a case the showing made by the claimant is insufficient to shift the burden of going forward to the asserted trustee.*

The above conclusions are in no way contradicted but rather are aided by the cases cited by appellee to which we have above made reference. In view of the fact that the federal courts have clearly announced the rules applicable to situations of the kind involved herein and have declared them to be matters in which they will not be bound by state decisions, we feel that it would in no way aid the court were we to undertake an analysis of the various state decisions cited by appellee to the points under discussion herein. In so far as the state decisions follow the rules declared by the federal courts a review of them is unnecessary. To the extent that some of them may differ and follow other tests in situations held by the federal courts to require an actual tracing, they are clearly irrelevant. As an actual fact the case of *Peters v. Bain* is determinative of this entire controversy for its rule of a strict tracing in cases of property purchased out of a commingled fund has never been deviated from by the Supreme Court of the United States.

5. The Principle of In re Oatway Has Never Been Followed in the Federal Courts to the Extent of Doing Away With the Strict Tracing Principle in Cases Dealing With the Acquisition of Real or Personal Property Out of a Commingled Fund.

Some stress was laid by the Master upon the decision of *In re Oatway* (1903), 2 Ch. D. 356, holding that where a trustee has invested the commingled funds in property (there stocks) and dissipated the balance, he may not asesrt that the property was acquired by his own money and that it was the *cestui's* money which was dissipated. This it will be seen is practically the converse of the Hallett rule. In effect it is a species of estoppel which prevents the trustee from claiming the benefit of the Hallett fiction. It may be conceded that the Oatway decision is declaratory of the law in England today.

But when we attempt to apply the principle of the Oatway decision to cases arising under the jurisdiction of the United States courts we are immediately beset with difficulties arising out of the strict tracing rules which the federal courts have invariably followed in cases of this nature. The *Oatway* case, it will have been perceived, does away with all pretense of tracing from the commingled funds into the acquired properties. In so doing it immediately runs foul of the definite holding of the Supreme Court of the United States in *Peters v. Bain* and *Schuyler v. Littlefield,* where a strict tracing was insisted upon before a trust might be impressed upon acquired property. It is also apparent that in each of the latter cases the Supreme Court was confronted by the same factual situation as that dealt with it the *Oatway* case, namely, properties (in the one case realty, in the other personalty) acquired by faithless trustees out of a

commingled fund which had later been dissipated. Moreover, a further fact should not be lost sight of, namely, that *Schuyler v. Littlefield* was decided in 1913, ten years after the decision in the *Oatway* case. From this situation but one conclusion may be drawn, namely, that the law as declared by the Supreme Court of the United States, both before and after the decision in the *Oatway* case, definitely requires an actual tracing of trust moneys when the acquisition of property, real or personal, by a trustee is concerned. From this it will be seen that the instant case is decidedly not one where speculation might be indulged in as to what the Supreme Court would do were it to be confronted with facts akin to those in the *Oatway* case. It has already been confronted with those facts, not once but twice, and has positively declared that an actual, as distinguished from a synthetic or fictional, tracing is required.

The reasons why the Supreme Court has not chosen to declare or follow the Oatway rule do not particularly concern us here. Yet one of these reasons may have been voiced by Judge Sanborn of the Circuit Court of Appeals for the 8th Circuit in *Empire State Surety Co. v. Carroll County, supra,* decided in 1912, nine years after the Oatway decision, when he stated:

> "Proof that a trustee mingled trust funds with his own and made payments out of the common fund is a sufficient identification of the remainder of that fund coming to the hands of the receiver, not exceeding the smallest amount the fund contained subsequent to the commingling (Board of Com'rs v. Strawn, 157 Fed. 49, 51, 84 C. C. A. 553, 555, 15 L. R. A. (N. S.) 1100; Weiss v. Haight & Freese Co. (C. C.) 152 Fed. 479; American Can Co. v.

> Williams, 178 Fed. 420, 423, 101 C. C. A. 634, 637), as trust property, because the legal presumption is that he regarded the law and neither paid out nor invested in other property the trust fund, but kept it sacred (Board of Com'rs v. Patterson (C. C.) 149 Fed. 229, 232; Spokane County v. First National Bank, 68 Fed. 979, 16 C. C. A. 81).
>
> "*For the same reason the legal presumption is that promissory notes, bonds and other property coming into the hands of the receiver were not procured by the use of, and are not, trust property.* Spokane County v. First Nat. Bank, 68 Fed. 979, 980, 16 C. C. A. 81, 82." (Italics ours.)

Such a conclusion is by no means an unnatural one. If the legal presumption in one case is that a trustee would not invest the trust moneys, it should be in another. Presumptions are not to be turned on or off like water from a tap. In the absence of proof of some sort as to what was done with the trust funds (and in the *Oatway* case there was none), it may well have been that the Supreme Court, having adopted the Hallett rule, felt that the "reversible presumption" advocated by the Chancery Division was straining things a bit too far. At any rate one fact is certain and that is that the Oatway principle does not stand as the law as declared by the Supreme Court of the United States.

The Master seemed to feel that the federal courts have followed the Oatway rule, referring specifically to *In re Pacat Finance Corporation,* 27 Fed. (2d) 810 (C. C. A. 2, 1928) and *Brennan v. Tillinghast,* 201 Fed. 609 (C. C. A. 6, 1913). It is true that the Oatway decision was cited in these two cases but it cannot be said that it was "followed", as far as our problem is concerned. More-

over, the circumstances which called for reference to it in the cases in question were hardly such as to afford intervener any comfort in the present matter. It must be borne in mind that we are here dealing with an attempt to follow trust moneys assumedly embodied in a commingled fund into specific items of property acquired by purchase from such fund, which was precisely the situation passed upon in *Peters v. Bain* and *Schuyler v. Littlefield.* In the *Pacat* and *Brennan* cases a portion of the commingled fund was set apart and commingled with other funds of the person against whom the trust was sought to be declared. In other words, *the money still remained money* and hence we find that the only effect of the two decisions in question was to apply the ordinary doctrine concerning trusts as to *commingled funds.* In no sense did either of the cases have anything whatever to do with the question of tracing trust moneys into properties acquired by the trustee. A brief reference to the facts in these cases will clearly demonstrate that they only go to the point of holding that a withdrawal from a commingled fund which is directly traceable to another fund equally under the control of the asserted trustee amounts but to a further commingling and that, therefore, both funds as a whole are subject to the right to reclaim. Clearly the principle of the *Oatway* case has little or nothing to do with such a situation as this.

In the *Brennan* case an insolvent bank wrongfully sold plaintiff's collateral and deposited the proceeds in another bank. (Commingling No. 1.) The insolvent then drew certain drafts against this account which were paid by the drawee to the insolvent in cash, the money remaining in the insolvent's vaults. (Commingling No. 2.) In holding that a trust might be declared against this cash later

coming into the hands of the receiver for the insolvent bank the court first referred to the Hallett presumption that the sums first drawn out should be deemed to be those which the tort-feasor had a right to expend in his own business and then stated as follows, citing the *Oatway* case in support (page 614):

> "And it is furthermore clear that this rule of presumption has no application where the evidence shows that the first moneys drawn out of the mingled fund by the tort-feasor were not in fact dissipated by him at all, *but were merely transferred, in a substituted form, to another fund retained in his own possession.* In such case, it must be held that the trust attaches to the substituted form in which the property is retained by the tort-feasor, and that the right to follow the trust in such form is not lost by reason of the fact that the tort-feasor thereafter draws out and spends for his own purposes the balance of the fund in which the trust money was originally mingled." (Italics ours.)

In the *Pacat* case the trust moneys were paid over to the bankrupt and by him deposited in his bank account. (Commingling No. 1.) The bankrupt then drew on this account and deposited the amount withdrawn to his credit in Italian money with a foreign banking house. (Commingling No. 2.) In its opinion the court stated (page 814) that it regarded lire credits as *cash in bank.* The Oatway doctrine was applied solely as a substitute for a dollar for lire identification of the moneys involved in the second transfer of funds.

When these two cases are analyzed it will of course be apparent that their only effect is to apply the doctrine of following into commingled funds to a situation where a

portion of the commingled fund is withdrawn and likewise mingled with another fund equally subject to the control of the party against whom the trust is asserted. While such a process theoretically involves a further dilution of the trust moneys it is not an unreasonable application of the tracing doctrine as heretofore applied to a commingled mass. The money still remains money and it is still in a fund under the control of the wrongdoer.

Clearly the two cases in no way alter the requirement which exists to this day in the federal jurisdiction that an actual tracing is required when real property purchases are involved. This same requirement likewise forbids the use of the two cases in question as authority for any claim that the standards of tracing into acquired real or personal property have in any way been changed. As we have seen, the Supreme Court has definitely declared that the standards in question have not changed.

When these considerations are taken into account it becomes reasonably apparent that the citation of the *Oatway* case in the two decisions to which we have made reference was wholly unnecessary. In the *Pacat* case, instead of simply declaring the principle that the new fund, due to direct infusion of moneys from the old, became subject to the charge upon the latter, the court apparently sought unnecessary justification for dispensing with proof of the tracing. This itself is silent but potent evidence of the fact that the court in question was rather strongly convinced either of its necessity or of the necessity of some adequate substitute therefor. Whether the *Oatway* case afforded a plausible basis for the court's position, however, remains to be seen. As a matter of fact the Oatway principle was not applicable to the facts of the *Pacat* case for a very obvious reason. The Oatway

doctrine is predicated upon (1) investment out of the commingled fund, and (2) dissipation of the balance. *In the Pacat case the commingled fund was not dissipated.* We quote (page 813):

> "At the time of bankruptcy a considerable balance remained in this account but Bernardini (the claimant) has expressly disclaimed any interest in this balance, all of which has been reclaimed by others. See *In re* Pacat Finance Corporation, *supra.*"

The latter case is reported in 295 Fed. at page 394 and on page 408 it appears that the amount on deposit in the Pacat bank account at the time of bankruptcy was the sum of $198,589.46. Since the amount of the trust funds advanced by claimant only approximated some $26,000.00, certainly no dissipation of the fund was shown within the meaning of the *Oatway* decision.

A reasonable analysis of the *Brennan* case likewise shows that the Oatway principle was thrown in as a mere gratuity. The case held, first, that the first moneys drawn from the commingled fund were merely transferred in a substituted form to another fund retained in the possession of the wrongdoer and, second, that the trust attached to the form in which the transferred moneys were held. This, and no more, was the true import of the decision. The court then stated that under the Oatway decision the right to follow the money into the transferred fund was not lost because the balance in the first account was later dissipated. Obviously if, as the court held, the transfer from one fund to the other carried the trust with it, nothing that happened afterward could affect the right to pursue the trust moneys into the second fund.

We, therefore, submit that no weight whatever should be attached to either the *Brennan* or the *Pacat* cases. They have nothing whatever to do with the matter of tracing asserted trust moneys into acquire properties. At the very most they permit funds in which trust moneys have been commingled to be followed from one pocket of the trustee to the other, which has nothing to do with tracing into real property. Even, however, if we assume the worst and take the view that each of the cases in question lent sanction through their citation of the *Oatway* case to the principle that a tracing into real property is shown merely by proof of purchases out of a commingled fund, coupled with a later dissipation of the balance, they would still be valueless as authority in view of the fact that the Supreme Court, not once, but twice has held directly to the contrary.

In addition to the decisions which we have discussed above, a number of cases in the various state courts have been referred to by appellee as tending to do away with the necessity of actual tracing, which has been stressed by the federal courts in cases involving attempts to trace the commingled funds into real property. As we have pointed out above, this case must be decided upon the rules declared by the federal courts and the agreement or disagreement of the various state courts as to those rules is not a matter of especial materiality in this proceeding. What we have said applies as much to the California case of *Mitchell v. Dunn,* 211 Cal. 129, as to cases from other state jurisdictions. As a matter of fact, *Mitchell v. Dunn,* does not purport to follow the Oatway rule, although it will be conceded that in effect it attains the same result. The decision of the Supreme Court in that case was based largely upon the fact that the rights of general creditors

were not involved, and, further, upon the application of the principles of *People v. California Safe Deposit Company,* 175 Cal. 756, which refused to follow the Hallett presumption in the case of a trust *ex maleficio,* a principle which would offer serious difficulties to intervener's theory of tracing in the present case.

We next come to a consideration of the question raised by the cross-appeal of Universal herein, namely, that of the proper low balance theory to be adopted in determining the extent to which the trust may be impressed upon the various properties, if the decision that there has been a sufficient tracing of trust funds be upheld.

6. If It Be Assumed That the Impressment of a Trust Upon the Properties Involved Was Proper, the Amount Thereof Could Not Exceed the Amount of the Lowest Balance in the Account Prior to a Given Purchase and Subsequent to the Last Deposit of Trust Moneys Therein, Such Low Balance to Be Computed by Deducting All Withdrawals From the Account During Each Day From the Opening Balance of Such Day, as Held by the Master and the Court.

It was practically conceded by cross-appellant that the extent of the trust which it sought to impress upon the various properties referred to in the Master's Report could not in any case exceed the amount of the lowest balance in the commingled fund prior to the date of any given purchase out of the commingled fund and subse-

quent to the date of the last deposit of trust moneys therein. The theory of replenishment by later deposits of the trustee's own money, to which cross-appellant apologetically referred to in its brief before the Master, has been expressly disavowed by the Supreme Court (*Schuyler v. Littlefield, supra*), and other Federal Court decisions.

Such being the case, we must first ascertain the true legal meaning of the term "lowest balance." Having done this, we must scan the evidence in the case in order to ascertain the showing which has been made in this connection.

Cross-appellant advanced three distinct theories for discussion under this head: first, that the closing balances of each day afford the true test; that if not the former, then the closing balances of each day as fortified by the few low intermediate daily balances shown by the bank records; and, lastly, if neither of the former methods be deemed to be correct, then the irreducible minimum afforded by the deduction from the opening balance of each day of all withdrawals made during the day irrespective of deposits shown. The Master, and hence the court, held this last method to be the proper one, and we submit the holding was correct.

Cross-appellant stressed the first method, namely, that of the opening and closing balances. No authority was cited by it in support of this position. It was held by the Master and the court that inasmuch as deposits and withdrawals throughout each day were shown, and inasmuch as cross-appellant failed to prove that the various deposits

preceded the various withdrawals during the day, the third method must be adopted. This reasoning was based largely upon the premise that subsequent deposits would not be allowed to replenish the sum (*Schuyler v. Littlefield, supra; In re Pacat Finance Co., supra*), and hence that cross-appellant must necessarily have proven the respective sequences of the deposits and withdrawals in order to make a showing, if such were the fact, that given deposits were made prior to given withdrawals. Cross-appellant failed to do this and hence there is no evidence whatever as to the matter of sequence. As far as the second theory is concerned, namely, that of the few low intermediate daily balances shown by the evidence, the evidence showed that those balances were in no sense a true indication of the status of the account, inasmuch as they were but the result of haphazard postings during the day, as to which the various bookkeepers would arbitrarily post certain items and ignore others irrespective of the order in which they actually passed through the bank. [Tr. pp. 98-101.]

The case of *In re Brown* (*supra*), 193 Fed., at page 26, fully supports the holding that the burden was on the claimant to show, if he could, the continuous state of the account. There the Special Master found that the opening and closing balances, which in that case were taken morning and afternoon, were in excess of the amount of money originally entrusted by the *cestui*. The court squarely held that upon the evidence before it such a

finding was insufficient to support a tracing, but that the Master and the District Judge might have had other evidence before them as to the continuous condition of the account and for this reason held the tracing insufficient on other grounds. We quote:

> "Moreover, it is not enough to show that there were morning and afternoon balances for several successive days large enough to cover the amount of money which was improperly converted. It might very well be that on any one day checks were presented which exhausted the morning balance and its accretions, in which event these moneys would have been dissipated. We are not prepared to assent to the proposition that subsequent deposits are to be taken as having been made to make good claimant's money thus drawn and spent. Board of Commissioners v. Strawn, 157 Fed. 51, 84 C. C. A. 553, 15 L. R. A. (N. S.) 1100. Our own conclusion would be that the $1,757.50 of the proceeds of claimant's stock, which went into the Hanover Bank on August 13th, has not been shown to be any part of the balance which was turned over by that bank to the trustee on September 5th. Nevertheless the master and the District Judge seem to have reached the conclusion that it remained in the account on August 24th. Since both of them had the same understanding of the law as that above expressed, viz., that the first check drawn on any given day might sweep away the balance carried over, and that it would be the merest speculation to assume that subsequent deposits restored the original situation, it is possible that they had some evidence, which is not in this record, as to the continuous condition of the daily balances prior to December 24th."

The above case would seem to be a complete answer to cross-appellant's contention regarding the opening and closing balances as being the proper test for the showing of low balances. As a matter of law, subsequent replenishments, as we have seen, are not to be taken as making good prior withdrawals. This means that the burden was clearly on cross-appellant to show that the respective deposits preceded the withdrawals, if such were the fact. If such were not the fact, the deposits could not, under the above rule, serve to replenish the withdrawals theretofore made. Hence, so far as this phase of the case is concerned, intervener clearly was entitled to no more than the "irreducible minimum" resulting from a total deduction of the withdrawals made during the day from the opening balance thereof. This it was awarded.

Cross-appellant naturally inveighs against the application of such a rule. No other alternative remains, however, in view of its failure to sustain the burden of proof cast upon it. If the burden were otherwise, the *Brown* case would have held the morning and afternoon balance controlling because of the failure of the *receiver* to prove the continuous condition of the account. The fact that difficulty may attend the making of proof such as required by the *Brown* case is no justification for the claim by cross-appellant that a finding should be made herein upon a theory which is wholly without justification from the evidence.

The reasons upon which the Master based his conclusions with regard to the proper low balance to be employed were eminently sound and we therefore set them forth as follows [Tr. pp. 150-156]:

> "It is my opinion that the balance which is properly to be used in applying the intervenor's theory

here is the third of those above described; that is, that which is shown by deducting all withdrawals posted during the day from the opening balance, without crediting deposits for the day.

The second above described, which results from periodical postings during the day of deposits and withdrawals, after crediting the opening balance, is not properly usable, for the reason that under the bank's practice, as above detailed, such balance disregards the actual order of deposits and withdrawals in point of time, and consequently does not reflect the true state of the account at any time.

The first above described, the so-called closing balance, is not usable, for the reason that by its nature it necessarily disregards the actual order of deposits and withdrawals in point of time, and consequently does not reflect the true state of the account at any time since the previous closing balance. To take it as an accurate reflection, it must be assumed that at the moment of each withdrawal, deposits had been received in an amount sufficient to leave a balance at least equal to that resulting from the whole day's transactions. Unless such an assumption is imperative, there is an equal likelihood that at any moment of the day the deposits previously received and the withdrawals then made may have produced a balance less than that resulting from the whole day's transactions, down to zero. Admittedly, the intervenor is not entitled to the benefit of a replenishment of the account after its reduction or exhaustion; yet the closing balance would necessarily yield that benefit, if during the day the account had been reduced or exhausted. Under the burden of proof which is on the intervenor, it cannot avail itself of the assumption which is implicit in the closing balance, in default of that direct evidence which might

have been provided by the striking of time-regarding balances during the day. The failure of the bank to strike balances of that conclusive character might, perhaps, in another situation, afford some reason for looking to the closing balances, as the best evidence of which the case admits, in view of banking custom; but in the present situation the intervenor, in tracing a trust fund into and out of a common account, is bound to better proof than that indicated, and finds it at hand in the facts which support the third description of balance. The other two being inadmissible, the intervenor must content itself with the third, else it must be without any proof at all.

'It is indispensable . . . that clear proof be made that the trust property or its proceeds went into a specific fund or into a specific identified piece of property.' (*Empire State Surety Co. v. Carroll County,* 194 Fed. 593, 604, C. C. A. 8.) 'No doubt the individual whose property has been converted has a high equity and is entitled to certain well-settled presumptions; but we cannot assent to the proposition that he may trace his money into any specific fund or security merely by inferences based on presumptions without substantive testimony to sustain them. The burden of proof is on the claimant at the outset; it rests upon him at the close of the case.' (*In re Brown,* 193 Fed. 24, 29, C. C. A. 2.) 'The burden of proof was upon the claimant to establish its ownership of the fund.' (*First Nat. Bank v. Littlefield,* 226 U. S. 110, 57 L. ed. 145, affirming *In re* Brown.) 'They were practically asserting title to $9,600.00, said to have been traced into stock in the possession of the trustee. Like all other persons similarly situated, they were under the burden of proving their title. If they were unable to carry the burden of identifying the fund as representing the proceeds of

their Interborough stock, their claim must fail. If their evidence left the matter of identification in doubt, the doubt must be resolved in favor of the trustee, who represents all of the creditors of Brown & Company, some of whom appear to have suffered in the same way. Like them, the appellants must be remitted to the general fund.' (*Schuyler v. Littlefield,* 232 U. S. 707, 58 L. ed. 807, affirming *In re* Brown.)

This burden relates to the actual, not the presumptive, balance. The actual order of withdrawals and deposits in point of time is therefore material. If the postings faithfully observe that order, actual balances will result. But they do not observe it in the present case, and it is necessary therefore to seek the fact elsewhere. It is not correct to say that the relation of debtor and creditor arises between the bank and its depositor only when the items are posted. When a depositor hands in a dollar bill, and the teller takes it, the bank immediately owes him one dollar. The indebtedness is not postponed to, nor conditional upon, the bookkeeper's act in noting it on a ledger. If the bookkeeper should never enter it at all, the depositor could nevertheless sue and recover it. The same applied to checks, conversely. If the bank should pay a check for fifty cents, it would be entitled to offset it in the depositor's suit for one dollar, whether the bookkeeper had ever noted it on the ledger or not. The question in both cases is one of fact, not of bookkeeping. Thus, in *In re* Brown, 193 Fed. 24, 28, the court, after referring to the bank's books, said: 'The officers of the bank, however, testified that the order in which the entries of debit and credit were made in the books was not necessarily the order in which the separate transactions actually took place. Much testimony was

taken in the effort to establish the real sequence of events.' And the court proceeded to find the real, as distinguished from the recorded, sequence of events. We are equally concerned here with the real sequence.

It is true that in *In re Brown,* the court said: 'We are clearly of the opinion that when the question is as to the disposition of a fund in a bank account, the time when certification is signed and noted by the bank is the significant time; it is then that the credit items which make up the balance of account are segregated by the bank as against the obligation assumed by certification. So long as such certification is outstanding, the bank would not allow any of the money thus appropriated to be drawn out.' But this really fortifies the position above taken, because it evidently means that the bank, in certifying a check, looks to the actual state of the account at the time, and that it adheres to this afterwards when new checks come in. This accords with the actual practice of the bank in the present case, for the evidence here is that the bank, in certifying checks and in paying checks over the counter, looks, not alone to the entries on the books, but to the unposted deposits and checks as well. The position of the court in *In re* Brown on the necessity for regarding the actual order of deposits and withdrawals is plainly declared by the following language:

'Moreover, it is not enough to show that there were morning and afternoon balances for several successive days large enough to cover the amount of

money which was improperly converted. It might very well be that on any one day checks were presented which exhausted the morning balance and its accretions, in which event these moneys would have been dissipated. We are not prepared to assent to the proposition that subsequent deposits are to be taken as having been made to make good claimant's money thus drawn and spent. Board of Commissioners v. Strawn, 157 Fed. 51. . . . Both of them' (the Master and the District Judge) 'had the same understanding of the law as that above expressed, viz., that the first check drawn on any given day might sweep away the balance carried over, and that it would be the merest speculation to assume that subsequent deposits restored the original situation.'

This disposes of any conception of the closing balance as usable for the intervenor's purpose. It disposes of any contention that the order of time may be disregarded in an inquiry of this sort. It affirms, what appears to be conceded here, that subsequent deposits do not restore a trust fund once reduced or exhausted; on which, among many authorities, may be mentioned Schuyler v. Littlefield, 232 U. S. 707, 58 L. ed. 806, and the cases there cited.

The result of the aforegoing is that the claim must fail, unless there is a minimum situation upon which the intervenor may rely; that is, a situation which assumes an order of deposits and withdrawals which at the worst must have occurred. Such a situation presents itself in a case where no deposits are made during the day in question, until all withdrawals of

that day have been effected. In that case, the order of withdrawals is indifferent, as they all precede the deposits. Now, it is a fact that withdrawals and deposits occurred each day, and that there was always an opening balance; whence some sort of balance, on one side or the other, continually resulted. This balance cannot be disregarded altogether, if there is a way of regarding it without detriment to defendants' position, correctly maintained as above stated. This position, that the time order must be observed, is preserved, and the proven existence of balances of some sort is recognized, by treating the deposits of the day as coming in after the withdrawals. As said by intervenor's brief, it 'establishes a minimum balance for each day below which it was impossible for the balance to have gone.' "

Conclusion.

We respectfully urge that the District Court erred in holding and deciding that upon the evidence and the Master's Report a sufficient tracing was established so as to warrant the imposition of a trust in any amount upon the properties referred to in the exceptions of this appellant. For this reason, we submit, the order overruling such exceptions and approving and confirming the report should be reversed.

As to the cross-appeal of Universal, we respectfully urge that, assuming a sufficient tracing, the low balance theory adopted and declared by the Special Master and

by the District Court was in all respects correct, and hence the order overruling the exceptions of cross-appellant should be affirmed.

Respectfully submitted,

Harry J. Bauer,
Alexander Macdonald,
Henry R. Schultheis,
Fred E. Pettit, Jr.,
A. S. Halstead, Jr.,

Solicitors for Appellants and Cross-Appellee George Armsby, F. S. Baer, Harry J. Bauer, Stanton Griffis, Robert E. Hunter and Albert E. Van Court, constituting the Richfield Bond Holders' Committee.

H. W. O'Melveny,
Walter K. Tuller,
Louis W. Myers,
Harry L. Dunn,
Clinton LaTourrette,
and
Pierce Works,

Solicitors for Appellant and Cross-Appellee Security-First National Bank of Los Angeles, as Trustee.